Reform of China's State-owned Banks a Success

Kwan Chi Hung
Senior Fellow,
Nomura Institute of Capital Markets Research

I. Introduction

China became serious about disposing of the nonperforming loans in its banking sector in response to the Asian financial crisis of 1997-98. In 2003, the big four state-owned banks (the Industrial & Commercial Bank of China, China Construction Bank, Bank of China, and Agricultural Bank of China), as well as the China Development Bank, began the process of reorganizing as joint stockholding companies in preparation for listing their shares. The objective of the first stage of reform, nonperforming loan disposals, was to overcome their negative legacies, while the second stage of reform, reorganization as a joint stockholding company, is aimed at improving corporate governance in the banking sector and turning the state-owned banks into genuine market actors. The banks that successfully carried out this strategy all the way to their IPO, the Industrial & Commercial Bank of China, China Construction Bank, and Bank of China, became the world's top three banks in terms of market capitalization as of end-March 2009.

II. From NPL disposal to reorganizing as joint stock companies

Bank reform in China began with the separation of private banks from the central bank in the early 1980s, was followed by the separation of commercial banks from policy banks in 1994, and then entered a new round after the Asian financial crisis of 1997-98. At the time, many overseas institutions and China watchers were estimating that China's big four commercial banks had nonperforming loan (NPL) ratios of 30-50%, and believed them to be insolvent. With the risk of a financial crisis growing, the Chinese authorities were committed to providing support to the big four banks.

In 1998, regulatory reforms allowed certain designated large state-owned enterprises (SOEs) to list their shares, and this lessened their longstanding reliance on state-owned banks for funding. In August of that year, China's Ministry of Finance issued RMB270 billion of long-term special treasury bonds, and used the proceeds to enhance the capital of the big four banks.

Next, to ease the pain of reforms and the tax burden on the state-owned banks, the Chinese government decided to lower the business tax by one percentage point per year over a three-year period, from 8% in 2000 to 5% in 2003. Although not completely solving their problems, this proved to be one of the most helpful measures for the big four banks, which had large business turnover but low profits.

Although this assistance from the government had some impact, it was still not enough, given the seriousness of the problems faced by the big four. Consequently, in 1999 the government established four asset management companies wholly owned by the Ministry of Finance: Xinda, Orient, Great Wall, and Huarong. By July 2000, these asset management companies had largely completed purchasing from the big four NPLs with a total book value of RMB1.4 trillion, with the intent of disposing of and collecting on the purchased loans by such means as asset sales, debt-equity swaps, and securitization. In November 2001, Dai Xianglong, the then governor of China's central bank, the People’s Bank of China (PBC), said that following these purchases by the asset management companies, the big four still had NPLs totaling RMB1.8 trillion. A simple calculation suggests that prior to the purchases, the big four's NPLs totaled RMB3.2 trillion, an extremely high 40% of their entire loan portfolios.

In December 2001, China joined the World Trade Organization (WTO), and promised to completely open its market to foreign banks within five years. The big four were uncompetitive with foreign banks on nearly every measure, including funding, service, and personnel, and there were concerns that they would lose market share, suffer profit declines, and see their businesses deteriorate.

To deal with this, the “Decision on Improvement of the Socialist Market Economic System,” issued by the Third Plenary Session of the 16th Central Committee of the Communist Party of China on 14 October 2003, included proposals to choose state-owned banks that meet certain conditions to reorganize as joint stock companies, accelerate their disposal of NPLs, increase their capital, and meet the conditions required for listing their shares.

In addition, at the global finance forum held several weeks later on 28-30 October, PBC Deputy Governor Li Ruogu made it clear that the reform of China's state-owned banks would proceed in three stages. The first stage was for them to solve the NPL problem. The second stage was for them to improve internal management, reorganize as joint stock companies, and operate based on corporate governance principles appropriate to a market economy. The third stage was for them to list their shares once they had met the criteria.

On 31 December 2003, the State Council invested a total of $45 billion of foreign currency reserves equally in the Bank of China (BOC) and the China Construction Bank (CCB). These two banks were chosen first because the BOC had the highest capital ratio of the big four, and the CCB had the lowest NPL ratio.

The entities that exercised their rights as major shareholders in the BOC and CCB and received profits and dividends from their investment were the Ministry of Finance and Central Huijin Investment Company Ltd., which was jointly capitalized by the People’s Bank of China and the State Administration of Foreign Exchange (SAFE). Subsequently, Central Huijin used foreign exchange reserves to invest $15 billion in the Industrial & Commercial Bank of China (ICBC) in April 2005, $20 billion in the China Development Bank to convert it from a policy bank to a commercial bank in

December 2007, and $19 billion in the Agricultural Bank of China in November 2008. The Bank of Communications, China's fifth largest bank and a joint stock company from the outset, received an investment of RMB3 billion from Central Huijin in June 2004.

To increase the banks' capital ratios, the authorities began allowing the issuance of subordinated debt to count as supplementary capital. In 2004 and 2005, subordinated debt totaling RMB147 billion was issued by four banks: ICBC, CCB, BOC, and the Bank of Communications. Some of the funds procured from the government's capital injections and from the issuance of subordinated debt was used to dispose of NPLs.

With the goal of NPL dispositions having been met, in August 2004, the Bank of China was reorganized as the Bank of China Co. Ltd. and the China Construction Bank as the China Construction Bank (Asia) and the China Construction Bank Co. Ltd. This was followed by the re-launching of the Industrial & Commercial Bank of China in October 2005, and the Agricultural Bank of China in January 2009, as joint stock companies, with the Ministry of Finance and Central Huijin as major shareholders.

III. From the participation of strategic investors to the listing of shares

Following the conversion of major state-owned banks into joint stock companies, the emphasis of reforms aimed at their public listing shifted to attracting strategic investors from overseas[1]. The objective was not only to enhance capital, but also to improve both managerial and governance capabilities. Meanwhile, one foreign financial institution after another has invested into one of the big four banks as a way to enter the Chinese market (Figure 1).

In August 2004, the Hong Kong and Shanghai Banking Corp. (HSBC) became the Bank of Communications' first strategic investor from overseas. By acquiring 19.9% of its shares, HSBC became the foreign financial institution with the largest stake in China's banking sector. Then in 2005, Bank of America acquired a 9.0% stake, and Temasek a 5.1% stake, in the China Construction Bank, and the Royal Bank of Scotland, UBS, the Asian Development Bank, and Temasek took a combined 16.19% stake in the Bank of China. In 2006, Goldman Sachs, Allianz, and American Express together invested $3.8 billion to purchase a 8.45% stake in the Industrial & Commercial Bank of China.

[1] In its Guidelines on the Corporate Governance Reform and Supervision of State-owned Commercial Banks issued on 18 April 2006, the China Banking Regulatory Commission (CBRC) required that strategic investors (1) take an ownership share of at least 5%, (2) invest for a period of at least three years, (3) fill a seat on the board of directors, provide senior management, and otherwise contribute management experience, (4) have a wealth of management skill and experience in the financial industry and a cooperative mindset, and (5) invest in no more than two state-owned commercial banks at the same time.

Figure 1: Banks' shareholder composition after the entrance of strategic investors

(%)

Commercial banks	Strategic investors	equity stake
Bank of Communications	Ministry of Finance	25.53
	HSBC (UK)	19.90
	National Council for Social Security Fund	14.22
	Central Huijin Investment	7.68
	Others	32.67
China Construction Bank	Central Huijin Investment	71.13
	China Construction Bank	10.65
	Bank of America (US)	9.00
	Temasek (Singapore)	5.10
	Shanghai Baosteel	1.55
	State Grid Corp. of China	1.55
	China Yangtze Power	1.03
Bank of China	Central Huijin Investment	79.90
	RBS (UK)	9.61
	Temasek (Singapore)	4.80
	National Council for Social Security Fund	3.91
	UBS (Switzerland)	1.55
	Asian Development Bank	0.23
Industrial & Commercial Bank of China	Ministry of Finance	43.28
	Central Huijin Investment	43.28
	Goldman Sachs (US)	5.75
	National Council for Social Security Fund	5.00
	Allianz (Germany)	2.25
	American Express (US)	0.45

Source: Nomura Institute of Capital Markets Research, based on each bank's annual report and prospectus.

The most critical step in the reform of China's state-owned banks was their listing on domestic and overseas markets, which subjected them to market scrutiny. The Bank of Communications listed its shares on the Hong Kong market in June 2005, ahead of the big four. The China Construction Bank was the first of the big four to list in the Hong Kong market, doing so in October 2005, and it followed that with a Shanghai market listing in September 2007. The Bank of China listed on the Hong Kong market in June 2006 and then on the Shanghai market right after that in July. The Industrial & Commercial Bank of China listed simultaneously on the Hong Kong and Shanghai markets in October 2006. Those listings raised a total of $21.9 billion ($16 billion from Hong Kong and $5.9 billion from Shanghai), surpassing the $18.1 billion raised by NTT DoCoMo in 1998 to become the biggest IPO in history. The Agricultural Bank of China, the last of the big four, is also making preparations to list its shares.

More than to raise funds, the main objective in listing the shares of state-owned banks was to achieve wholesale change in the banks' management by diversifying ownership. As noted by PBC governor Zhou Xiaochuan, "the reorganization to a joint-stock company and IPO forces the state-owned banks to meet the disclosure requirements of listed companies. Listing creates the necessary conditions for

Figure 2: Substantial improvement in the financial indicators of state-owned banks that reorganized as joint stock companies

(% and RMB billions)

		2003	2004	2005	2006	2007	2008
Industrial & Commercial Bank of China	Capital ratio	−8.81	−8.31	9.89	14.05	13.09	13.06
	NPL ratio	21.24	18.99	4.69	3.79	2.74	2.29
	Pretax profits	2.66	2.11	59.35	71.52	115.11	145.30
Bank of China	Capital ratio	5.39	10.04	10.42	13.59	13.34	13.43
	NPL ratio	16.28	5.12	5.41	4.04	3.12	2.65
	Pretax profits	38.57	34.58	55.14	67.63	89.96	86.25
China Construction Bank	Capital ratio	6.51	11.29	13.57	12.11	12.58	12.16
	NPL ratio	4.27	3.92	3.84	3.29	2.60	2.21
	Pretax profits	37.47	50.22	55.36	65.72	100.82	119.74
Bank of Communications	Capital ratio	7.41	9.72	11.20	10.83	14.44	13.47
	NPL ratio	—	2.91	2.37	2.01	2.05	1.92
	Pretax profits	4.06	7.12	12.84	17.41	31.04	35.82

Source: People’s Bank of China, (China Financial Stability Report), 2009 (in Chinese)

achieving public monitoring. Accordingly, capital injections from the government are significant not only because they improve the bank's balance sheet, but also because they help create a new financial intermediation mechanism that makes efficient use of savings. In fact, it is not until there is the kind of external pressure produced by a share listing that it becomes possible to establish and improve upon corporate governance. This facilitates the abandonment of the old bureaucratic management approach while guaranteeing that commercial bank reform succeeds." (“Various problems with the reform of state-owned commercial banks” *Financial News* [*Jinrong Shibao*], 31 May 2004 [in Chinese]).

Privatization, in the sense of not only listing the shares but also gradually phasing the government out of both ownership and management, is probably the ultimate objective of reform of the state-owned commercial banks. This joint-stock reorganization and listing for the big four banks is merely a first step toward that end. Even if the banks succeed in forming an internal, rules-based system of corporate governance, there is no guarantee of an effectively functioning incentive system and management oversight mechanism. A bank can be transformed into a corporation with a board of directors, a board of auditors, a general shareholders' meeting, and other management structures, but as long as the government remains in control as the largest shareholder, the usual problems are unlikely to be solved. This is why it is desirable, once the Big Four have listed their shares, to start the process of privatization by reducing the government's stake.

Figure 3: China's banks as global leaders

a) Market cap basis, 31 March 2009

Rank	Bank	Country	Market capitalization ($ billions)
1	Industrial & Commercial Bank of China	China	187.9
2	China Construction Bank	China	133.2
3	Bank of China	China	115.2
4	JPMorgan Chase	US	99.9
5	HSBC	UK	97.4
6	Wells Fargo	US	60.3
7	Banco Santander Central Hispano	Spain	56.2
8	Mitsubishi UFJ Financial Group	Japan	56.1
9	Bank of America	US	43.7
10	Itau Unibanco	Brazil	42.6

b) Pretax profit basis, 2008

Rank	Bank	Country	Pretax profits ($ billions)
1	Industrial & Commercial Bank of China	China	21.26
2	China Construction Bank	China	17.52
3	Banco Santander Central Hispano	Spain	15.83
4	Bank of China	China	12.62
5	Banco Bilbao Vizcaya Argentaria	Spain	9.64
6	HSBC	UK	9.31
7	Barclays Bank	UK	8.86
8	Agricultural Bank of China	China	7.66
9	Uni Credit	Italy	6.95
10	Royal Bank of Canada	Canada	6.08

Source: Nomura Institute of Capital Markets Research, with market cap figures from FT500 Companies at FT.com (http://www.ft.com/ multimedia/interactive) dated 29 May 2009 and pretax profit figures from Top 1000 World Banks 2009, The Banker, July 2009.

IV. Transforming into some of the world's top banks

Beginning with their reorganizing as joint stock companies, state-owned commercial banks have improved their level of service and efficiency by building internal auditing and risk management structures, while at the same time adapting to global standards, improving their corporate governance, and transforming their management structure.

In this process of becoming joint stock companies and listing their shares, the state-owned commercial banks have quickly improved their financial indicators, their profitability, and their ability to manage risk (Figure 2), reporting considerably higher capital ratios, and substantially lower NPL ratios, in 2008 than they did in 2003. They also greatly increased their pretax profits.

With the share prices of banks in Japan, the US, and Europe having dropped sharply during the latest financial crisis that started in the US in September 2008, as of 31 March 2009 the top three banks in the world based on market capitalization were the Industrial & Commercial Bank of China ($187.9 billion), the China Construction Bank ($133.2 billion), and the Bank of China ($115.2 billion), well ahead of fourth-ranked JPMorgan Chase Bank ($99.9 billion) and HSBC ($97.4 billion), as shown in Figure 3a. Based on 2008 pretax profits, the Industrial & Commercial Bank of China ranked first, the China Construction Bank second, and the Bank of China fourth (Figure 3b).

This is evidence that the reforms taken by the state-owned banks, including their conversion to joint stock companies and listing of shares, were quite successful.